REINSURANCE ASSOCIATION OF AMERICA

STATEMENT

TESTIMONY

OF

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PRESIDENT
REINSURANCE ASSOCIATION OF AMERICA

STABILIZING INSURANCE MARKETS FOR COASTAL CONSUMERS

BEFORE

THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTITIES

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Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee:

My name is Franklin Nutter and I am President of the Reinsurance Association of America (RAA). It is an honor to appear before you on behalf of the RAA. I would like to thank you Chairman Baker, and many of the members of the House Financial Services Committee and Ways and Means Committee for the strong leadership on the issue of natural disaster financing. This is an issue of upmost importance to the RAA and we greatly appreciate the Members' commitment to this issue and look forward to working with Members on both Committees on market-based solutions.

The RAA is a national trade association representing property and casualty organizations that specialize in reinsurance. The RAA membership is diverse, including large and small, broker and direct, U.S. companies and U.S. subsidiaries of foreign companies. Together, RAA members write nearly 2/3 of the gross reinsurance coverage provided by U.S. property and casualty reinsurers and affiliates.

Reinsurance is commonly referred to as the insurance of insurance companies. Reinsurance plays a critical role in maintaining the financial health of the primary insurance marketplace and ensuring the availability of property and casualty insurance for U.S. consumers and businesses. Reinsurance is used for several reasons. One of the most common purposes is for a primary insurance company to transfer the potential risk of losses from catastrophic events such as hurricanes, earthquakes, and in the case of September 11, 2001, acts of terrorism. To that end, reinsurers have assisted in the recovery after virtually every major U.S. catastrophe over the past century. For natural disasters typically one-third of the insured losses are passed on to reinsurers and in the events of September 11, two-thirds of the losses were absorbed by the reinsurance industry.

As cited in an August 2006 A.M. Best Report: "Several factors…contributed to the insurance industry's stability in 2004-2005:

- Transference of risk to the growing global reinsurance market
- Greater use of capital market solutions"

The resilient private insurance market system worked as it should to absorb losses from extreme natural events in 2005 through retained losses by insurers (37%) and substantial risk transfer to global reinsurers (63%).

Reinsurance Role in 2004-2005 Hurricane Seasons

There are many factors that affect the stability of insurance in coastal areas, reinsurance being a key factor. The important role reinsurance plays in coastal areas and in our nation's economy was demonstrated during the 2004 and 2005 hurricane seasons. As you are aware, in 2004 there were four major hurricanes that hit Florida resulting in $30 billion of damage. The global reinsurance industry paid approximately one-third of those losses, enabling insurance companies who purchased reinsurance to honor their obligations to their homeowner policyholders. Despite the huge financial impact to reinsurers, there were no reinsurer insolvencies and the reinsurance market was able to meet the primary insurance community catastrophe demand for the 2005 hurricane season.

As has been well documented the hurricane season of 2005 turned out to be a year of unprecedented losses in terms of frequency and severity. The insurance/reinsurance industry weathered the single largest loss in the industry's history (Katrina). Insured Katrina losses were an estimated $45 billion, even greater than the projected $35 billion in 9/11 losses. The 27 named hurricanes and tropical storms in 2005 set a new record, an aggregate total of $80 billion in insured losses. The Big Three: Katrina, Rita and Wilma produced losses estimated to be as high as $60 billion. The reinsurance industry once again played a critical role, providing stability to the insurance market, by paying approximately 60% of all of these losses. The 2005 hurricane losses were spread well throughout the global reinsurance markets: Bermuda $11 billion; U.S. reinsurers $7 billion; London/Lloyds $6 billion; European reinsurers $6 billion.

The 2004-2005 hurricane seasons are indicative of risk transfer from insurers to reinsurers. Notwithstanding nearly $30 billion in catastrophe losses in 2004, U.S. primary companies had their first underwriting profit since 1978 and net income of $41.7 billion. In 2005 U.S. insurers had record net income of $49 billion and growth in surplus to $433 billion notwithstanding U.S. catastrophe losses of $58 billion. Reinsurers in the U.S., on the other hand, incurred $1.44 in loss costs and expenses for every $1 of premium. Global reinsurers in 2005 lost $1.20 for every $1 in premium. In 2005 the Bermuda reinsurance market, which provides nearly 40% of U.S. property catastrophe reinsurance, lost 25% of its capital base due primarily to U.S. catastrophe risks.

Reinsurance Capacity Today and its Impact on Coastal Insurance Stabilization

What does that mean for reinsurance capacity to provide natural disaster protection for primary insurance companies in coastal areas for 2006? Despite the unprecedented losses in 2004 and 2005, private market reinsurance capacity increased in 2006. Estimates are that the reinsurance capacity in place increased nearly 30%.

As it has following all recent catastrophe events, the free market responded to the increased demand for reinsurance. As in 1993 after Hurricane Andrew and 2001 after the terrorism losses of 9/11, the capital markets promptly provided new reinsurance capital and capacity. The same dynamic occurred after 2005. Since Hurricane Katrina, approximately $24 billion in new capital has been raised to support underwriting needs notably for U.S. catastrophe risk. Of that capital, $7.780 billion was invested in new start up reinsurance companies; the remainder replenished the capital positions of existing (re)insurers. In addition to that new capacity, an additional $4 billion has been invested in special purpose vehicles, whose investors, such as hedge funds, collaborate to provide extra underwriting capacity to existing reinsurers for property and catastrophe retrocessions and other short tail lines of business. Reports are that $4 to $6 billion (estimated) of catastrophe bonds was invested in U.S. catastrophe exposure.

Despite this new capacity, there are still insurance market dislocations in Florida and in some areas of the Gulf Coast. Demand increased in some peak zones in 2006, notably the Gulf Coast and Florida, at a greater rate than the reinsurance supply increase due to: rating agencies requiring greater capital to support catastrophe exposure, catastrophe modelers increasing loss predictions; growth in both population and property values in certain high-risk areas; changed perspectives on frequency and severity of storms and insurance company managements' desire to purchase more protection. Rating agencies such as A.M. Best and Standard & Poors determined that insurers and reinsurers with catastrophe exposures needed additional capital to support their ratings. Insurance catastrophe modelers revised their models following the hurricane seasons in 2005 due to new data and a belief that we are entering into an era of increased hurricane frequency and severity. Reports are that Florida catastrophe models increased 60% for frequency and 40% for severity. The Gulf Coast models were revised for a 20% increase in frequency and 15% for severity. Insurance company managements also have reacted due to a changed perception of risk. Such managers have seen the impact of increased hurricane frequency and severity on their losses and seek to purchase more reinsurance protection. The confluence of these events has resulted in demand for catastrophe protection in peak catastrophe zones greater than the supply.

The RAA believes this imbalance will be temporary, however. As the events after Hurricane Andrew suggest, typical insurance and reinsurance cycles involve temporary spikes in pricing, followed by new market participants, leading to increased competition and price moderation. Ultimately, free markets will create a more diversified insurance and reinsurance market that will spread risk widely, increasing capacity and price competition.

Conclusion

Reinsurance plays a critical role in the stabilization of insurance markets. We recognize that after some hurricane seasons, there will be temporary market dislocations as reinsurance demand exceeds supply. The RAA looks forward to working on market-based solutions with you Chairman Baker and other Members of Congress who have already demonstrated leadership and commitment to this most important issue.